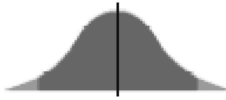

Park Piedmont Advisors LLC

Registered Investment Advisor

**VICTOR LEVINSON** **NICK LEVINSON, CFP®**

## JANUARY 2007 COMMENTS

**WINTER TRAVEL PLANS:**
Vic will continue to spend the winter working in Florida. All his contact information remains exactly as it is when he is in New York; all phone calls are forwarded into his cell phone number, 917-741-5450. Send all regular mail and faxes to Lynette in the New York office.

**PORTFOLIO UPDATES for INTERNATIONAL INVESTMENTS:**
We are currently reviewing portfolios to establish appropriate allocations to international investments, which include Vanguard's Total International index fund, and Vanguard's Emerging Market ETF (investments explained in detail in the November 2006 Comments). These allocations are advocated by David Swensen in his book, "Unconventional Success" (pp. 57-66), which we cite frequently, as an appropriate diversification to investments in the US stock market. The use of these international investments is not therefore based on any market timing decision that they will outperform US investments in any particular time frame.

**LONG-TERM CARE INSURANCE:**
For those of you who do not have this insurance and have an interest in obtaining it, please let us know, as we are able to provide advice on this subject.

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*Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.*

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## COMMENTS: INDEX RESULTS for period ending JANUARY 2007

| STOCKS | YEAR 1999 | YEARS 2000-02 | YEARS 2003-05 | YEAR 2006 | YTD 2007 | JAN. 2007 |
|---|---|---|---|---|---|---|
| Vanguard Total Stock Market Index Fund (1) | 23.8% | (37.2%) | 53.1% | 15.5% | 1.9% | 1.9% |
| Standard & Poors 500 Index (2) | 19.6% | (40.1%) | 41.9% | 13.6% | 1.4% | 1.4% |
| Vanguard S&P 500 Growth Index Fund (1) | 28.8% | (48.4%) | 41.8% | 9.0% | 2.7% | 2.7% |
| Vanguard S&P 500 Value Index Fund (1) | 12.6% | (26.2)% | 63.2% | 22.1% | 0.9% | 0.9% |
| Dow Jones Industrial Average Index (2) | 25.2% | (27.5%) | 28.5% | 16.3% | 1.3% | 1.3% |
| NASDAQ Composite Index (2) | 85.6% | (67.2%) | 65.2% | 9.5% | 2.0% | 2.0% |
| Vanguard Midcap US Index Fund (1) | 25.0% | (18.3%) | 83.9% | 13.6% | 3.6% | 3.6% |
| Vanguard Smallcap US Index Fund (1) | 19.6% | (24.2%) | 87.5% | 15.6% | 2.4% | 2.4% |
| Vanguard International Index Fund (EAFE) (1) | 25.3% | (45.9%) | 95.9% | 26.6% | 1.0% | 1.0% |
| Vanguard Emerging Markets Index Fund (1) | 61.6% | (29.5%) | 162.7% | 29.4% | (0.6%) | (0.6%) |
| Vanguard Real Estate Investment Trust Fund (1) | (0.4%) | 47.5% | 98.6% | 35.1% | 8.5% | 8.5% |
| **BONDS** | | | | | | |
| Vanguard Total Bond Market Index (1) | (0.8%) | 30.4% | 11.1% | 4.2% | (0.1)% | (0.1)% |
| Vanguard Intermediate Tax- Exempt Index Fund (1) | (2.9%) | 23.7% | 10.3% | 4.4% | ( 0.3)% | (0.3)% |
| Vanguard Short-term Bond Index (1) | 2.1% | 25.8% | 6.5% | 4.1% | 0.2% | 0.2% |
| Vanguard Short Tax- Exempt Index Fund (1) | 2.6% | 13.8% | 4.5% | 3.2% | 0.2% | 0.2% |
| Vanguard High-Yield Bond Fund (1); starting 2002 | NA | 1.7% | 30.7% | 8.2% | 0.6% | 0.6% |
| Vanguard Inflation-Protected Bond Fund (1); starting 2001 | NA | 25.5% | 20.0% | 0.4% | 0.2% | 0.2% |

NOTE: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of first year, the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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| % | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | **1999** | | | | **2000** | | | | **2001** | | |
| **S&P 500** | 4.1 | 7.6 | (7.7) | 15.6 | 2.0 | (3.0) | (1.3) | (7.8) | (12.1) | 4.8 | (13.8) | 8.1 |
| **NASDAQ** | 14.6 | 10.0 | 0.0 | 61.0 | 12.4 | (14.8) | (7.2) | (29.6) | (25.5) | 12.9 | (26.7) | 18.3 |
| **BONDS** Interm. Tax. | 0.0 | (0.5) | 0.4 | (0.7) | 2.4 | 1.5 | 3.1 | 4.3 | 3.2 | 0.8 | 4.3 | 0.0 |
| | | **2002** | | | | **2003** | | | | **2004** | | |
| **S&P 500** | 0.0 | (13.8) | (14.1) | 4.5 | (1.8) | 12.8 | 2.2 | 13.2 | 1.3 | 1.3 | (2.4) | 8.8 |
| **NASDAQ** | (5.5) | (19.5) | (13.5) | 7.0 | 2.5 | 19.2 | 12.1 | 16.2 | (0.5) | 2.7 | (7.5) | 13.9 |
| **BONDS** Interm. Tax. | 0.0 | 2.8 | 3.6 | 1.8 | 0.9 | 2.7 | 0.2 | 0.2 | 2.7 | (2.6) | 3.1 | 1.0 |
| | | **2005** | | | | **2006** | | | | **2007** | | |
| **S&P 500** | (2.6) | 0.9 | 3.1 | 1.6 | 3.7 | (1.9) | 5.2% | 6.6% | | | | |
| **NASDAQ** | (8.1) | 2.6 | 4.4 | 2.5 | 6.1 | (7.6) | 3.9% | 7.1% | | | | |
| **BONDS** Interm. Tax. | (0.5) | 3.0 | (0.7) | 0.6 | (0.7) | (0.2) | 3.8% | 1.3% | | | | |

## JANUARY 2007 COMMENTS

**STOCK** index prices were mostly higher in January, even with lower bond prices (see next paragraph). Thus for the second consecutive month, stock and bond prices moved in different directions. The competing views of a weakening economy and a relatively strong economy continue to impact investment results, with no clear-cut resolution of the different points of view. For the month (and YTD), the S&P 500, Dow, NASDAQ, and Total Stock Market (TSM) index, which includes Midcap and Smallcap stocks, showed results of +1.4%, +1.3%, +2.0%, and +1.9%, respectively. Monthly results (and YTD) for Midcap, Smallcap, International and Emerging Market indices were +3.6%, +2.4%, +1.0% and (0.6)%, respectively. The REIT index gained 8.5% for the month, continuing its remarkable outperformance.  However, Largecap Value underperformed Largecap Growth, reversing its multi-year outperformance, at least for one month. See page 2 for all pertinent figures for the month, YTD, and since 1999.

**BOND** returns (price change plus interest) were lower in January for the second consecutive month, after five consecutive months of gains. The benchmark 10-year US Treasury yield closed at 4.82%, well above the November low of 4.47%, but still well below the current 5.25% short-term overnight rate set by the Federal Reserve. However, 10-year yields are not likely to continue below short-term yields for any considerable length of time, since the normal relationship (also known as the "yield curve") of 10-year yields to short-term yields is positive 200 bps or more, not negative 43 bps. The conflicting views of the economy, referred to in the previous paragraph, are at work in this "inverted" yield curve environment. Therefore, we are likely to see either rising longer-term rates or declining shorter-term rates in the coming months. Monthly (and YTD) returns ranged from –(0.3)% to +0.2% for high credit quality bonds with short and intermediate maturities, while high yield junk bonds continued to show better results. See page 2 for results for the month, YTD, and since 1999.

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The stock market rally that began decisively in March 2003 is now almost four years old. But given the declines of the preceding three years (2000-02), investment returns for the seven years since the start of 2000 are still far below their long term historical averages, with the Dow Jones up 10%, the S&P 500 down (2)%, and the NASDAQ down a stunning (40)%. (See Chart I on page 11). In a fascinating observation, the mutual fund company Vanguard notes that since 1926, through 2005, in only six of 80 years did stock prices fall within 2%, up or down, of the long-term annual average return of 10.4%.

Going back to the beginning of 1994, when the spectacular 94-99 bull market began, all three major indexes have remarkably similar average annual returns (ranging from 9.9% to 10.3%) that are close to the 10.4% average annual return of the stock market dating back to 1926. As these returns converge, the idea of "regression to the mean," described by Swensen as "one of the most powerful influences in the world of finance" (pg. 154), comes clearly into focus. And yet, the Vanguard observation noted above is also meaningful, since the annual returns during the bull market period were far higher than the long-term average annual return. **The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, in the context of a fairly stable very-long-term average return. The key question for You?? What is Your relevant time frame??**

| | S&P 500 (1) | | DOW (1) | | NASDAQ (1) | |
|---|---|---|---|---|---|---|
| 1st Qtr 2000 High | 1,527 | | 11,723 | | 5,048 | |
| Year End 2000 | 1,320 | (13)% | 10,785 | (8)% | 2,470 | (51)% |
| September 21, 2001 Low | 965 | (37)% | 8,235 | (30)% | 1,425 | (72)% |
| Year End 2001 | 1,148 | (25)% | 10,020 | (17)% | 1,950 | (61)% |
| October 9, 2002 Low | 777 | (49)% | 7,286 | (38)% | 1,114 | (78)% |
| Year End 2002 | 880 | (42)% | 8,342 | (29)% | 1,336 | (73)% |
| Year End 2003 | 1,112 | (27)% | 10,454 | (11)% | 2,003 | (60)% |
| Year End 2004 | 1,212 | (21)% | 10,783 | (8)% | 2,175 | (57)% |
| Year End 2005 | 1,248 | (18)% | 10,718 | (9)% | 2,205 | (56)% |
| Year End 2006 | 1,418 | (7)% | 12,463 | +6% | 2,415 | (52)% |
| Year-to-date 2007 | 1,438 | (6)% | 12,622 | +8% | 2,464 | (51)% |

## Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

| | S&P 500 (1) | DOW (1) | NASDAQ (1) |
|---|---|---|---|
| End 1994 | 459 | 3,834 | 752 |
| End 1999 | 1,470 | 11,500 | 4,070 |
| Gain | 1,011 | 7,666 | 3,318 |
| Avg.Ann.%Gain:'95-'99; 5 years | 26.2% | 24.6% | 40.2% |
| January 2007 | 1,438 | 12,622 | 2,464 |
| Gain | 979 | 8,788 | 1,712 |
| Avg.Ann.%Gain:'95-1/07; 12.1 yrs | 9.9 % | 10.3 % | 10.3 % |

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

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# I. UPDATE OF KEY ECONOMIC INDICATORS

The strength of the overall US and world economies is one of a number of factors likely to influence the future direction of both stock and bond prices. We, along with many market observers and academics who write about the markets, believe stock and bond prices already reflect consensus expectations of economic growth. Further, we believe that even if you could accurately predict any number of actual economic figures, the market's reaction to those figures is essentially unpredictable. In any event, an understanding of the direction of current economic trends may at times be useful as a context to help understand market conditions. This section of the Comments provides an update of key economic indicators.

(1) Gross Domestic Product (GDP) is the broadest measure of goods and services produced in the US economy (GDP figures are inflation-adjusted, annualized growth rates). The initial reading for Q4 GDP growth showed a rate of 3.5%, "much better than 2% in the third and 2.6% in the second quarter, as consumer purchasing offset a sharp drop in housing" (Wall Street Journal [WSJ], 2/1/07, A2).

(2) Employment grew by 110,000 jobs in January, a "lukewarm result,…but the tone was not entirely soft, as revised data showed employers added 80,000 more workers in November and December than initially thought, making the monthly average new job figure over the last three months 170,000" (WSJ, 2/3-4/07, A3).

(3) Interest Rates on longer-term bonds increased in January for the second consecutive month, with the benchmark 10-year US Treasury interest rate, which is set by buyers and sellers in the bond market, closing at 4.82%. This was an increase of 11 bps above the prior month's close, but still 43 bps below the overnight rate of 5.25%, which is controlled by the Federal Reserve. During January, the Fed "left the target for short term interest rates at 5.25%, for the fifth consecutive meeting (WSJ, 2/1/07, A2). The 10-year yield was as high as 5.25% in June, and declined to as low as 4.47% in November, coinciding with the Fed's stopping (after June) its campaign of raising short-term rates. The fact that the yield curve is still sharply inverted, with overnight rates almost 1/2 of 1% higher than the 10-year Treasury, is discussed on page 3.

(4) Inflation rates, as measured by the "core" Consumer Price Index (CPI), which excludes the volatile food and energy sectors, "rose 0.2% in December after remaining flat or falling in the three previous months. With food and energy included, the CPI rose 0.5%. Compared with a year earlier, overall prices rose 2.5% and core prices were up 2.6%" (WSJ, 1/19/07, A2). The Producer Price Index (PPI), which measures what businesses charge one another, rose 0.9%, "but core wholesale prices rose a moderate 0.2%... For all of 2006, wholesale prices rose 1.1% overall, while core prices rose 2.0%." (WSJ, 1/18/07, A2). (Note: The CPI measures prices of goods and services; the PPI, only goods).

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(5) Sector Economic Activity Showed Signs of an Improving Economy

(a) Durable goods orders (industrial and consumer) gained 3.1% in December, with the core rate (ex-defense and aircraft), up 2.4% (WSJ, 1/27-28/07, A3).

(b) Industrial production (which includes manufacturing, utilities and mining) "grew 0.4% in December, after three straight months of decline,…while capacity utilization remained at 81.8%, up from 81.3% a year earlier, but below its 1994-1995 high of 85.1% (Vanguard Economic Week in Review [VEWR], 1/19/07).

(c) Retail Sales gained 0.9 in December, "and were up 5.4% from December a year ago, compared to December to December growth of 5.7% in 2005" (WSJ, 1/12-13/-7, A3). (Retail sales are not adjusted for inflation, and include such disparate categories as gasoline, autos, and the Internet).

(d) Housing sales for existing homes fell 0.8% in December, and were "down 8.4% from 2005, the largest annual decline since 1989…; even with the drop, 2006 was the third strongest year since 1968 (when records began to be kept by the National Association of Realtors)" (WSJ, 1/26/07, A2). New home sales rose 4.8% in December, but "fell 17.3% in 2006, the largest decline since 1990" (WSJ, 1/27-28/07, A3).

(e) Personal Income increased 0.5% in December, while personal spending rose 0.7%, reaching four month and six month highs, respectively. (Both figures are unadjusted for inflation) (VEWR, 2/2/07).

(6) Consumer Confidence, as measured by the Conference Board's Index, "remained relatively unchanged in January, and is at its highest level since May 2002" (VEWR, 2/2/07).

(7) Corporate Profits for Q4 2006 "are coming in up about 10% above Q4 2005, which would mark the 14th quarter in a row of double digit profit gains" (WSJ, 1/27-28/07, B1). The importance of corporate profits is discussed at length in the following section, beginning on page 7.

Overall, January's economic news pointed to an improving economy, with inflation under control. A recent WSJ summary article (2/3-4/07, A9) stated that "recent news seemed to confirm the views of many analysts who believe the US economy has entered a "Goldilocks" phase – not so hot that it causes inflation but not so cold that it spurs a serious economic slowdown." Whether the economy is able to generate economic growth at a rate that keeps inflation under control, thereby allowing the Federal Reserve to keep from raising interest rates; or whether economic growth and inflation accelerate, forcing the Fed to raise interest rates; or whether growth and inflation diminish, moving the Fed to lower rates; continues to be a major theme in the pricing of the current stock and bond markets. Corporate profits, a second major theme driving stock prices, are discussed in detail next.

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## II. KEY FACTOR FOR STOCK PRICES: CORPORATE PROFITS AND PRICE/EARNINGS ("P/E") RATIOS

Recent articles in the financial press have begun to discuss the likely slowdown in the growth of corporate profits, and the impact of such a slowdown on stock prices. Some examples of these articles include:

"Even as the stock market has zoomed to records this autumn (*our note: this applies to only certain parts of the stock market*), investors have been paying relatively little for each dollar in corporate profits. That is because earnings have enjoyed an even longer, more frenzied boom of their own, up more than 10% every quarter for more than three years running. Now, as fourth quarter results are beginning to roll in, stocks could start to look more expensive relative to companies' earnings. Many Wall Street pros have been predicting that heady profit growth will slow in coming months while share prices continue to rise… According to both Reuters and Thompson Financial (*our note: two financial reporting firms*), the S&P 500 is trading at less than 15 times this year's expected earnings, which is cheap compared with long-term averages of about 20 times earnings" (*our note: see below; we prefer to use 15 times earnings as the long term historical average*) (WSJ, 1/16/07, C1).

In discussing recent stock price volatility, the WSJ asked: "What's behind the volatility? Uncertainty about what investors consider the two most important stock market drivers: profits and interest rates. The issue in a nutshell: the pace of profit growth has slowed markedly from the 19% gain registered in the third quarter… Profit gains still are above historical average,…but not quite as good as they were, which makes investors nervous… Profits are coming in about 10% above the year earlier quarter, according to Thompson Financial. That is above the long term average of 7%, and would be the 14th quarter in a row of double digit profit gains, but profit gains for last year's third quarter were nearly twice as good – up about 19%" (WSJ, 1/27-28/07, B1).

Since the stock market had such a favorable result over the final six months of 2006, and has had four consecutive years of gains; and since many investors take the recent performance of stock prices and believe that performance will continue into the indefinite future, we think it very important to step back and fully understand the potential implications of a slowdown in corporate profits on stock prices.

First, some basic points:

1) Stock prices are determined by a number of factors, a very important one being the level of corporate profits now and as projected into the future. A key question for stock investors is how many dollars they are willing to pay now for a dollar of any particular company's current and projected future profits. For example, if a company has $1 per share of profits, and its stock sells for $15 per share, then that company's price to earnings (P/E) ratio is said to be 15 (earnings and profits are synonymous, and used interchangeably).

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2) Corporate profits are counted in dollars, and then converted to a per share figure based on the number of shares the company has issued to the public at various times in its corporate history. Some large companies have profits in the billions of dollars, and numbers of shares in the billions, so that reducing these large numbers to a dollar profit per share is an effort at simplification. Profits/earnings per share is referred to as EPS.

3) There are many ongoing issues that arise from the P/E calculations, which include:

a) Why different companies, all with similar EPS, sell for widely different stock prices. In other words, Company A, B, C and D, all with $1 EPS, can sell for $10, $15, $20, or $25 per share, resulting in P/E ratios of 10, 15, 20 or 25; and

b) How earnings are calculated. There are many, many issues here; two major current issues are (i) the expensing of stock options (see WSJ articles from 1/30/07, C5, and 1/20-21/07, B3), and (ii) the reporting of pension plan gains, losses, and liabilities (see WSJ, 1/23/07, A4).

4) As companies have P/Es, so too does the broad stock market. For instance, the 500 companies in the S&P 500 can all have their respective earnings and shares calculated, and the index itself assigned a P/E. Currently, the S&P 500 index has a P/E of approximately 15. If the index is selling at around 1400, that would mean all the companies in the index have a combined EPS of $93. It should be clear that if EPS does not increase, then the share prices will not increase, unless the P/E ratio gets larger. At $93 EPS, and a 20 P/E, the S&P 500 index would be priced above 1800, rather than its current 1400; conversely at a 10 P/E, the price of the S&P 500 would decline to 930.

It should follow from the basic points above that the two major variables in the stock pricing equation are: (1) EPS, and (2) the multiple the market assigns to EPS (the P/E ratio).

Over the past few years, EPS has been rising rapidly (see first two articles cited at length on pg. 7), and so the advance of stock prices could follow without requiring any major expansion of the P/E ratio. So if the P/E of the stock market (S&P 500) has remained at approximately 15 for the past few years, it means investors continue to pay $15 for every $1 of corporate earnings. Even if the prices of stocks have gone up, these higher prices have been supported by higher earnings.

Now if EPS growth declines to, say, 7% in 2007, any gain in stock prices above 7% would require investors to pay more than the 15 P/E. As P/Es get higher, stock prices become more vulnerable to declines. While the factors that make a given P/E reasonable in one time frame, and too high or too low in another time frame, are many and varied, the 15 P/E has been considered a reasonable historical average.

The warning here is that the recent past favorable results for stock prices have been supported by favorable reported EPS growth. If that EPS growth slows down, it is likely that stock prices will be impacted. As you know, PPA does not attempt to predict the future, or engage in trying to time the ups and downs of market prices, but we do think providing some cautionary information offers a useful reminder that there is risk in the markets along with the opportunities for gains.

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## III. INVESTMENTS WE USE TO IMPLEMENT YOUR ASSET ALLOCATION

We began this section late last year, in an effort to provide clients with additional information about the specific investments we use. For this month, we have chosen two such investments:

1) Real Estate Investment Trust ("REIT") stock funds, which invest in companies that develop, manage, and invest in real estate located in the US; and
2) High Yield bond funds, which invest in a wide range of bonds that pay relatively high rates of interest due to the generally lower credit quality of the borrower/issuer.

**REIT index fund**:
Key Statistics for Vanguard's REIT index fund (symbol VGSIX):
1) Size: $6 billion
2) Annual Expenses: 0.21%, or $21 on a $10,000 investment
3) Load: None
4) Annual Yield: 3.66%
5) PE Ratio: 35.5
6) % in Top 10 Holdings: 39%
7) Top Sectors (as of 2/6/07): REITs, 100%
8) 2006 Return: 35.1%

REITs are a special type of company that allows for investment in various types of real estate. These companies can avoid taxation if they earn more than 75% of their income from real property and distribute at least 95% of their earnings to shareholders. As such, they typically pay relatively higher income yields than other stock investments, and so are appropriate to own in tax-deferred retirement accounts. There are Equity REITS, which buy and sell ownership interests in real estate, and Mortgage REITs, which lend money to real estate developers. Both Equity and Mortgage REITS can invest in various types of real estate, including offices, industrial buildings, apartments, hotels, and storage facilities.

Vanguard's REIT fund is based on Morgan Stanley's REIT index, which consists of 106 REIT stocks. Started in 1996, VGSIX invests in almost all of these companies, and has more than $6 billion in assets. The fund owns a few very large REITs, with the top 10 stocks comprising almost 40% of the fund's value. Only the top three (Simon Property Group, Equity Residential, and Equity Office Properties), however, are in the S&P 500 index of the largest US stocks. This relative lack of representation in the broad-based largecap stock index is one of the main reasons we recommend this fund as an investment. In other words, the REIT fund provides diversification in the stock portion of clients' portfolios.

Although we do not recommend this (or any other fund) fund based on past performance, it is worth noting that REIT funds have been among the best-performing investments since 2000. While the broad-based US and international stock markets crashed from 2000-02, REITs rose almost 50%. REITs also performed strongly in the recovery years from 2003-05. And in the context of a significant downturn in the ownership housing market, REITs were the highest returning category in 2006, with VGSIX up more than 35%. These significant price gains have adversely affected the historically high income yields, however, pushing them down from the 5-10% range to 3.66% in 2006.

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**High Yield Bond fund**:

Key Statistics for Vanguard High Yield Corporate Bond fund (symbol VWEHX):

1) Size: $5 billion
2) Annual Expenses: 0.25%, or $25 on a $10,000 investment
3) Load: None
4) Annual Yield: 7.03%
5) Average Maturity: 6.3 years
6) % in Top 10 Holdings: 11%
7) Top Issuers (as of 1/8/07): Communication, 20%; Consumer, 19%; Utilities, 15%
8) 2006 Return: 8.2%

Last month, we discussed the Total Bond Market fund, which consists of more than 2,750 individual bonds covering most parts of the high-credit quality bond market in the US. This high yield bond fund invests instead in bonds issued by companies with relatively low credit quality. This category includes new companies that have not yet established themselves as "safe" borrowers (i.e., very likely to repay their debts), as well as troubled companies whose businesses have encountered significant problems. For example, debt issued by Ford, which lost more than $12 billion last year, is among the top 10 holdings in the Vanguard fund.

Vanguard's High Yield Corporate Bond fund is based on Lehman's High Yield index. Started in 1978, VWEHX invests in 286 bonds, and has more than $5 billion in assets. The basic concept of this type of bond, which was previously referred to as "junk" and was involved in the downfall of Michael Milken in the 1980s, is that the issuers have to pay higher interest rates to induce lender/investors to invest in the debt of companies with questionable prospects. The current yield on VWEHX is just over 7%, compared with 4.85% for Vanguard's Total Bond Market fund, which consists of high-credit quality bonds with maturities comparable to those in VWEHX. The appeal of the mutual fund structure becomes apparent in this case, because one or more of the 286 bonds in the fund can (and are actually expected to) default without decimating the entire investment.

Whereas high credit-quality bonds are most affected by changes in current interest rates, high yield bonds are typically more subject to the factors, such as corporate profitably (see discussion above on pages 7-8), that move stock prices. With the generally improving economic climate from 2003 through 2006, and continuing through the first month of 2007, high yield bonds have earned significantly higher returns than more traditional bond categories. (Conversely, high yield bond performance was much worse during the stock bust years from 2000-02.) With the higher returns, however, have come decreasing "spreads" between high yield bonds and US Treasury bonds, which are considered to have no default risk. Such reductions in the "risk premium" investors typically demand has led many commentators to opine that this might cause significant price declines for high yield bonds if economic conditions worsen in the next few years. Without making any predictions about what might happen over short time periods in the near future, we continue to believe that high yield bond funds such as VWEHX can be a useful part of a well-diversified bond portfolio, especially if held in a client's tax-deferred account.

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| | S&P 500 (1) | | DOW JONES (1) | | NASDAQ (1) | |
|---|---|---|---|---|---|---|

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

**I. Figures From Period Starting 2000 (% Figures Are Cumulative Declines From 1/01/00)**

| | S&P 500 (1) | | DOW JONES (1) | | NASDAQ (1) | |
|---|---|---|---|---|---|---|
| **Start of 2000** | 1,470 | | 11,500 | | 4,070 | |
| **End of 2000** | 1,320 | (10.1)% | 10,785 | (6.2)% | 2,470 | (39.3)% |
| **Sept. 21, 2001 Low** | 965 | (34.3)% | 8,235 | (28.4)% | 1,425 | (65.0)% |
| **End of 2001** | 1,148 | (21.9)% | 10,020 | (12.9)% | 1,950 | (52.0)% |
| **Oct. 9, 2002 Low** | 777 | (47.1)% | 7,286 | (36.6)% | 1,114 | (72.6)% |
| **End of 2002** | 880 | (40.1)% | 8,342 | (27.5)% | 1,336 | (67.2)% |
| **End of 2003** | 1,112 | (24.3)% | 10,454 | (9.1)% | 2,003 | (50.8)% |
| **End of 2004** | 1,212 | (17.5)% | 10,783 | (6.2)% | 2,175 | (46.5)% |
| **End of 2005** | 1,248 | (15.1)% | 10,718 | (6.8)% | 2,205 | (45.8)% |
| **End of 2006** | 1,418 | (3.5)% | 12,463 | +8.4% | 2,415 | (40.7)% |
| **Through Jan. 31, 2007** | 1,438 | (2.2)% | 12,622 | +9.8% | 2,464 | (39.5)% |

**II. Figures From Period Starting 1995 (% Figures Are Gains From 1/01/95)**

| | S&P 500 (1) | | DOW JONES (1) | | NASDAQ (1) | |
|---|---|---|---|---|---|---|
| **Start of 1995** | 459 | | 3,834 | | 752 | |
| **End of 1999** | 1,470 | | 11,500 | | 4,070 | |
| **5 Year Gain; Annualized %** | 1,011 | 26.1% | 7,666 | 24.6% | 3,318 | 40.2% |
| **End of 2002** | 880 | | 8,342 | | 1,336 | |
| **8 Year Gain; Annualized %** | 421 | 8.5% | 4,508 | 10.2% | 584 | 7.5% |
| **End of 2004** | 1,212 | | 10,783 | | 2,175 | |
| **10 Year Gain; Annualized %** | 753 | 10.2% | 6,949 | 10.9% | 1,423 | 11.2% |
| **Through Dec. 31, 2006** | 1,418 | | 12,463 | | 2,415 | |
| **12 Yr Gain; Annualized %** | 959 | 9.9% | 8,629 | 10.3% | 1,663 | 10.2% |
| **Through Jan. 31, 2007** | 1,438 | | 12,622 | | 2,464 | |
| **12.1 Yr Gain; Annualized %** | 979 | 9.9% | 8,788 | 10.3% | 1,712 | 10.3% |

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